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CITATIONS

626079—45

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 725

MOLLIE NETCHER NEWBURY, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Claims (R. 33–39) is reported in 57 F. Supp. 168. The concurring opinion of Judge Madden (R. 40–42), in which Judge Whitaker joined, is also reported therein.

JURISDICTION

The judgment of the Court of Claims was entered on October 2, 1944 (R. 43). The petition for a writ of certiorari was filed on December 2, 1944 (R. 43). The jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925, as amended by the Act of May 22, 1939.

QUESTION PRESENTED

Whether the income beneficiary of a certain trust who also had a remainder interest subject to invasion for the benefit of other beneficiaries is entitled, under Section 23 (l) of the Revenue Acts of 1934 and 1936, to an allowance for depreciation on trust assets not absorbed by the trust income, where the trust instrument as construed by the court below required that the trustee, in determining the distributable income, should withhold an amount sufficient to offset depreciation.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.[1] In computing net income there shall be allowed as deductions:
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> * * * * *
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> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income benefi-

[1] Similar provisions are contained in Section 23 (l) of the Revenue Act of 1936, c. 690, 49 Stat. 1648.

ciaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (l)-1.[2] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. In the case of property held by one person for

[2] Similar provisions are contained in Article 23 (l)-1 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, will be allowed to the remainderman. In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee.

STATEMENT

The special findings of fact of the Court of Claims (R. 26–33) may be summarized as follows:

Petitioner is the widow of Charles Netcher and is also trustee of a trust created under the will of her husband of which she is one of the beneficiaries. This suit is brought by her in her individual capacity. (R. 26.)

By the will of Charles Netcher who died on June 19, 1904, his wife and four children surviving (R. 26), his entire estate, aside from a special bequest to his widow, was left in trust, the widow being named trustee. One-third of the net income from the trust estate was to be paid to her for life, and she was granted the power, by will or deed, to dispose of the right to such income from the date of her death until the termination of the trust. The income from the remaining two-thirds of the estate was to be divided by the trustee into four equal portions, each of such portions to be thereafter held in trust by the trustee as a separate fund for each of the decedent's children. (R. 28–29.)

It was further provided by the will that until each of such children attained the age of twenty-five years respectively, the trustee should use and expend so much of each separate trust fund held for each child as in her opinion was necessary for the education and support of such child. On attaining his or her twenty-fifth year each child was to become entitled thereafter to receive one-fourth of the entire net income of the above mentioned two-thirds of the principal trust es-

tate. (R. 33–34.) The instrument further provided that at any time after the children had reached the age of twenty-five, the trustee might pay over to any child in her discretion the sum of $25,000 and after attainment of the age of thirty years the trustee might pay over to the child the sum of $100,000, both such payments to be made out of the separate trust fund provided for the benefit of the child to whom such payments are made, or if such separate trust fund was not sufficient then out of the principal of the principal trust estate, provided (R. 29)—

> it be not necessary to sell any of the real estate in Block Fifty-eight (58) of the Original Town of Chicago, in Cook County, Illinois, for the purpose of making such payments, it being my wish that said real estate in said Block Fifty-eight (58) shall be held together for the benefit of my entire Estate and the beneficiaries thereunder, subject to the power of sale or other disposition hereinafter given to the executor or executors, trustee or trustees under this Will.

One of the assets included in the estate was real estate in Chicago, Illinois. Following the decedent's death the widow, acting as trustee under the will, borrowed the necessary funds and erected on this property a 17-story fireproof store and office building at a cost of $5,714,759.52 which was thereupon leased to the Boston Store. (R. 27.)

For the calendar years 1935, 1936, and 1937 the sum of charges for ground rent, interest on mortgage, taxes, and depreciation exceeded the rents from the building by considerable amounts. These deficits were treated as part of expenses of the so-called principal trust already referred to. The charges for depreciation for each of the years were reasonable allowances for losses sustained through exhaustion, wear, and tear of the building. In computing the distributable net income of the trust created by the will, the trustee has continuously deducted from the gross income of the trust estate an allowance for loss sustained through exhaustion, wear, and tear of improvements, and has set up a reserve to cover the loss so sustained. (R. 27–28.)

The Commissioner of Internal Revenue determined that depreciation sustained on properties of the principal trust estate in the taxable years was deductible only by the trustee in computing net income of the trust and that any depreciation thus set up and consequently reported in the net loss of the estate was not subject to deduction by the individual beneficiaries from income received by them from other sources. (R. 32.)

As a result of this action by the Commissioner of Internal Revenue, deficiencies were determined and assessed against the petitioner for the years 1935, 1936, and 1937 and were duly paid. Timely claims for refund were rejected and this suit was

brought in the Court of Claims within two years of such rejection. (R. 32–33.) The Court of Claims sustained the Commissioner and rendered judgment against the petitioner (R. 33–42, 43).

ARGUMENT

The question of whether certain of the income beneficiaries under the trust created by the will of Charles Netcher were entitled to depreciation deductions for the year 1937 was decided in favor of the Government by the Circuit Court of Appeals for the Seventh Circuit in *Commissioner* v. *Netcher*, 143 F. 2d 484. That court held that although the will contained no specific provisions as to depreciation, it was clearly the testator's intention that the trustee and not the beneficiaries should take the depreciation deduction. Certiorari was denied in that case on October 23, 1944 (No. 418).

The holding of the Court of Claims that the petitioner, another beneficiary under the same trust, is not entitled to the depreciation deduction, is in accord with that of the Seventh Circuit. In fact, the petition for certiorari in this case raises substantially the same issues as were raised there and, for this reason, we do not believe it necessary to discuss the various issues raised in the petition at any great length.

The holding of the court below was based upon the ground that the provisions of the will rather

clearly "expressed the intention and desire of the decedent that a deduction for depreciation of the trust property should be taken by the trustee for the Trust Estate in determining the net income distributable to the beneficiaries" (R. 37). Since Section 23 (l) of the Revenue Acts of 1934 and 1936, *supra*, pp. 2–3, provides that in the case of property held in trust the allowable deduction for depreciation shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the trust instrument, the beneficiaries are clearly not entitled to the deduction for depreciation but, as the court below held, the trustee is the only one entitled thereto.[3]

Petitioner attempts to distinguish her situation from that of the beneficiaries in the *Netcher* case upon the ground that she was not merely a life beneficiary but had a remainder interest as well[4]

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[3] The petitioner and the other beneficiaries for many years took the view that the trustee was required to set up a depreciation reserve, and in an earlier case relating to their income taxes for the years 1923 to 1925 (*Newbury* v. *Commissioner*, 26 B. T. A. 101), the Board of Tax Appeals so held, and the Commissioner acquiesced (XI-2 Cum. Bull. 7 (1932)).

[4] The provision in the will that after the termination of the trust one-third of the principal trust estate and accumulations was to be conveyed to the widow (petitioner herein), if living, or, if dead, to others designated by her, was not included by the court below in its special findings of fact (R. 26–33). However, the entire will was in evidence in the court below (Exhibit 1, attached to the stipulation of facts

and that, as the holder of an equitable fee interest she had the right to depreciation deductions (Pet. 5, Br. 12–14). In the first place, however, petitioner's remainder interest in the corpus was subject to invasion if necessary to make the $25,000 and $100,000 payments to the children (R. 29). Under the applicable Illinois law, moreover, petitioner certainly does not have an equitable or a legal fee, as she may be suggesting (Br. 12–14), for even aside from this possibility of invasion, the trust here established was not a "dry or passive trust", and there could be no merger of her life and remainder interests. *Burbach* v. *Burbach*, 217 Ill. 547; see 1 Scott on *Trusts*, sec. 99.3.

Petitioner relies upon the provision, in Section 23 (l), that in the case of property held by one person for life with a remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. She urges that since the life tenant may take a depreciation deduction, she, having more than a life interest, certainly may. But petitioner ignores, as she did in the court below, the provisions in Section 23 (l) dealing specifically with property held in trust. These provisions first appeared in

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filed by the parties), and the pertinent portion may also be found in the petition in the court below (R. 6).

the Revenue Act of 1928 and have been in all succeeding Revenue Acts. As Judge Madden said, in the court below (R. 42):

> It was not possible, in the statutory scheme, to treat the trust situation exactly like the legal life tenant and remainder situation, since in the latter case there is frequently no ascertainable person to represent the permanent interest in the property, and even if there is such a person, he has no income from it. It probably seemed fair to Congress, therefore, to give the life tenant the depreciation allowance even though the loss is, largely, not his loss, rather than to deny any depreciation allowance to anyone.

The Committee Reports relating to the 1928 Act [8] clearly show that there was to be a distinction between the situation of an ordinary life tenant where the deduction was to be computed as if the life tenant were the absolute owner of the property and accordingly allowed to him and that of a beneficiary under a trust where the deduction was to be allocated between the trustee and the beneficiaries. Those reports contain the following example where the property is held in trust:

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[8] S. Rep. No. 960, 70th Cong., 1st Sess., p. 20 (1939-1 Cum. Bull. (Part 2) 409, 423); H. Rep. No. 1882, 70th Cong., 1st Sess., pp. 11-12 (1939-1 Cum. Bull. (Part 2) 444, 445).

> * * * if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee.

This example was incorporated in the regulations, and it has remained unaltered therein for many years. Article 201, Treasury Regulations 74 and 77; Article 23 (l)–1, Treasury Regulations 86, 94 and 101; Section 19.23 (l)–1, Treasury Regulations 103; Section 29.23 (l)–1, Treasury Regulations 111. It is entitled, therefore, to substantial weight in construing the statute. *Taft* v. *Commissioner*, 304 U. S. 351; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Magruder* v. *Washington, B. & A Realty Corp.*, 316 U. S. 69.

The holding of the court below is in accord with the statute and these regulations, and the petitioner is not entitled to the claimed deduction for depreciation.

CONCLUSION

The decision of the court below is correct. There is no conflict and the petition should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
SEWALL KEY,
ROBERT N. ANDERSON,
ELIZABETH B. DAVIS,
Special Assistants to the Attorney General.

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